



## DEPARTMENT OF STATE

Washington, D.C. 20520

February 3, 1983

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~~SECRET~~MEMORANDUM FOR W. ALLEN WALLISFROM: M. J. Bailey *MJB*

SUBJECT: "Hard Currency" and Other Arguments for Trade Embargoes

The talking papers and assessments I have seen on reasons for denying western exports of oil and gas technology to the Soviets seem to me to need improvement. In discussing the arguments, I will take for granted the problem of Western vulnerability to a gas cutoff, which arises from the inflexibility (heavy capital intensity) of the pipeline system. It's the other arguments that need work. These concern the wisdom of buying gas or anything else from the Soviets, and of selling them oil-field equipment. There is one good argument for embargo of all oil and gas-related equipment, which I have not seen in any of the relevant papers, and three bad ones, which I have seen. I accept without discussion the CIA estimate that an effective COCOM embargo would set back Soviet oil and gas development by about two years. In so doing it would reduce their net energy exports and could conceivably make them net energy importers by 1990. I can't vouch for the reliability of this estimate, but have no basis for challenging it.

The one good argument is that so long as the Soviet are net energy exporters they have a financial interest, in addition to their political interest, in disrupting Middle Eastern oil supplies. By the end of the 1970's they were collecting about \$10 billion a year in extra revenue from oil sales alone (plus smaller sums from gas and from gold) due to the big increases in their prices. The Soviets had contributed directly to these price increases by providing arms and mischievous encouragement to Egypt, Syria, and Iraq. (As an extra bonus they are now selling arms to Syria and Iraq for hard cash, paid for at the gas pumps of Europe and the U.S.) If Western countries aid Soviet oil and gas development with advanced equipment, the Soviets will continue to have a financial incentive to disrupt the Middle East; that is, they can get their political gains, such as disrupting NATO, at a cash profit. It is in our interest to remove that incentive, if we can.

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The bad arguments are the following:

1. The Soviets use hard currency earnings for political and clandestine uses that we oppose; therefore we should try to deny them hard currency earnings.

2. Hard currencies are becoming increasingly scarce for the Soviets; limiting those earnings will impose heavy economic burdens on the Soviets.

3. Purchase of cheap Soviet gas will block the development of safety-net measures and alternative sources to protect against a gas cutoff.

The reasons these are bad arguments follow, with matching numbering.

1. Political  uses of Soviet hard currency earnings that we oppose represent a small fraction, perhaps ten percent,\* of the uses of those earnings. An effective embargo might cut the earnings by as much as forty percent. In response to that, the Soviets might cut a little from the small budget of sensitive items, but only the lowest-priority uses. Because that program has a priority for them similar to their military budget; they won't cut it back in any way that they perceive as harming their vital interests.

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2. It is true that reducing trade with the Soviets would impose economic burdens on them; it would also impose burdens on the Western economies. Just as trade increases the real resources available to the Soviets, some of which they can devote to their military, it increases the real resources available to Western economies. With these extra resources, the Western countries can better defend themselves. An example is Soviet oil and gas exports, which (apart from the good argument noted above) lower world energy prices and so strengthen Western economies. The thing to look at is how the gains from trade are divided between East and West. If it makes sense to try to tilt the terms of trade more in favor of the West, an embargo is not the way to go about it.

3. Cheap Soviet gas will lower the cost of such safety-net measures as gas storage, and if the purchase lowers energy prices generally it will probably also lower prices of oil and gas drilling equipment. Therefore it is likely to lower the cost of developing alternatives such as the Troll gas field. If Western governments respond rationally to the opportunity, it will be cheaper and therefore politically easier to take the necessary steps for energy security, whatever those steps may be. That is, it will if selling gas is the only way the

\*inferred from CIA data.

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Soviets intervene in energy markets. However, if the Soviets mean to disrupt oil markets and then threaten to cut off gas at the same time (and if they can do so at a profit), that's another matter; it is also another argument.

In sum, the last three arguments, alone or in combination, don't make sense. It may well be that developing Troll field is an important, efficient part of a prudent safety-net program for Western energy security, and that the purchase of more Soviet gas would reduce that security intolerably. It may also be that prudence requires an allied embargo on all exports of oil and gas related equipment to the Soviet Bloc. The bad arguments won't help us get from here to there.

More detailed analysis of these points is in the works. The first attached table shows Soviet revenue gains from oil supply disruptions in the past ten years, and their hard currency arms sales. The second attached table shows projections of Soviet hard currency earnings to 1990, with and without an allied embargo of oil and gas equipment and technology.

Attachment:

Table

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(1) Actual Value of USSR Oil Exports to Free World Countries (\$ million)	(2) Value of USSR Oil Exports to Free World Countries, if no Supply Disruptions (\$ million)	(3) USSR Revenue Gain from Supply Disruptions (\$ million)	(4) Hard Currency Arms Sales (\$ million)	(5) Gold Sales (\$ million)
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		(a) Constant Rel. Price	(b) Rel. Price Grows 10% per year	Column (1) Minus (2) (a)	Column (1) Minus (2) (b)		
1970	607	607	607	0	0	35	0
1971	865	865	865	0	0	50	24
1972	865	865	865	0	0	0	239
1973	1,664	1,004	1,104	660	560	250	962
1974	3,766	959	1,160	2,807	2,606	250	1,178
1975	4,410	1,220	1,624	3,190	2,786	1,200	725
1976	5,900	1,585	2,321	4,315	3,579	1,500	1,369
1977	6,976	1,817	2,927	5,159	4,049	1,500	1,618
1978	7,170	2,056	3,642	5,114	3,528	1,700	2,522
1979	12,330	2,062	4,019	10,268	8,311	5,500	1,490
1980	15,819	2,193	4,701	13,626	11,118	3,300	1,580
1981	16,004	2,213	5,218	13,791	10,786	5,000	2,700

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SOVIET HARD CURRENCY EARNINGS  
(Billion 1981 US \$)

A. Expanded Gas Sales

	<u>1981</u>	<u>1985</u>	<u>1990</u>
Total, Current Account of which	32.8	25 to 34	33
Oil	11.5	1 to 10	0
Gas	3.4	4.0	12.7

B. No further gas sales; effective COCOM Embargo  
of all oil and gas technology and equipment

	<u>1985</u>	<u>1990</u>
Total, Current Account of which	25 to 34	20
Oil	1 to 10	-10
Gas	4.0	9.5

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